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April 30, 1997

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APR 30 1997

Federal Communications Commission
Office of Secretary

The Honorable Reed E. Hundt
Chairman
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: Access Reform (CC Docket 96-262) and
Universal Service (CC Docket 96-45)

Dear Chairman Hundt:

I appreciated the opportunity to meet with you last week to discuss the Commission's upcoming access reform and universal service decisions. These critical proceedings will have a profound impact on the industry for years to come.

I am enclosing a copy of the ex parte filing we made today with the Commission to respond more fully to certain concerns that you had raised in our meeting.

A. You can achieve all of your regulatory objectives without increasing the 5.3% productivity factor.

You expressed concern that the 5.3% productivity factor may have to be increased in order to provide sufficient access cost reductions to permit long distance carriers to fund their new and existing universal service obligations without raising their toll rates. As the financial analysis contained in Attachment 1 demonstrates, no change in the productivity factor is required to accomplish those objectives.

If the universal service support mechanisms for education, libraries and rural health care providers are fully funded on July 1, 1997, long distance carriers will see only a transitory cost increase overall, and will soon see significant benefits under the existing price cap mechanisms. Moreover, with two modest modifications to the current plan, even this transitory negative effect disappears completely. Those modifications are to collect funding for the new universal service support for schools, libraries and rural health care providers on an "as needed" basis, and make the SLC increase for multiline business effective July 1, 1997. With regard to universal service, it is widely acknowledged that the institutions benefiting from the new universal service programs will not be able to spend the full projected funding on day one; instead, their funding needs will ramp up over time. This practical and expedient approach to universal service funding will cushion the long distance carriers from any adverse financial impact, while access rate levels continue to be reduced using the current 5.3% productivity factor.

We also discussed our concern that an increase in the current productivity factor could force rates for some companies below the 10.25% rate of return that the Commission has previously determined give a company the ability to increase rates. If the Commission were to decide to increase the productivity factor in a way that forces companies to choose a productivity factor that is higher than 5.3%, which it should not do, Attachment 2 describes a step-by-step procedure to ensure that any rate reductions are capped in order to avoid imposing that result on any company.

B. The long distance carriers are free to set their own rate structure.

You also expressed concern that long distance carriers might be unable to pass on to their customers new flat rate per line charges, resulting in further revenue reductions for these carriers in the face of increased universal service obligations. This simply is not so for several reasons:

- Long distance carriers today already pay access charges that are a mix of flat rate and usage charges. Although a greater portion of their costs after access reform will be flat-rated rather than usage-based, their overall costs will <u>not</u> increase.

- The structure of access charges does not determine how long distance carriers recover those costs from their toll customers. Long distance companies, as non-dominant carriers, have wide latitude to recover their costs from their customers through a variety of pricing mechanisms -- alone or in combination -- that can ensure full cost recovery. In short, if the long distance companies made no change in their pricing plans, they would still incur the same costs and could collect the same revenues that they do today.

- A restructure of access charges that results in lower usage rates will provide an opportunity for the long distance carriers to increase their earnings significantly.

We do agree with long distance carriers, however, that the Commission's proposed per line rate charge for multiline businesses of $4.50 is too high, and urge the Commission to adopt a lower cap of $2.00 to smooth the transition to greater flat rate recovery of costs without adverse competitive and financial impacts.

AT&T has argued that, regardless of the pricing flexibility it may have with other customers, its long term fixed contracts with the federal government will require it to pass on the lower access usage rates but absorb the higher flat rate charges. AT&T's argument that it lacks contractual remedies to address these restructured charges is suspect for reasons addressed more fully in Attachment 3. But before the Commission gives any credence to AT&T's claim that its contracts with government customers preclude it from passing on such federally mandated charges, AT&T should be required to put the relevant contractual provisions on the record and state for the record that it will pass through the lower usage charges but will not pass through the higher flat rate charges to these customers. Even if AT&T is unable to negotiate a change in its contract rates to address these new circumstances, which it can, it would be unfair and against the public interest to force access rates lower simply to protect AT&T from the financial impact of the one-sided contract it negotiated.

C. Long distance carriers will benefit from lower access usage rates.

Finally, you asked how demand for access services would be affected by lower access charges. The enclosed analysis by Charles J. Zarkadas and Agustin J. Ros of NERA (Attachment 4), explains that the effect on access service demand depends on whether and how long distance carriers pass on to their toll customers these reduced usage charges. If they fully flow through all per minute reductions to their customers, the benefits to long distance carriers would be significant; long distance demand would increase and long distance carriers would see a net contribution increase (price minus incremental cost) of more than $1.6 billion. Moreover, as usage-based access charges continue to be reduced through application of the 5.3% productivity factor and the increase in Subscriber Line Charges, long distance carriers will see even greater benefits.

I trust that this additional analytical data will be helpful to the Commission in resolving these critical issues.

Sincerely,

Encl.

cc: Commissioner James H. Quello
Commissioner Rachelle B. Chong
Commissioner Susan Ness
Mr. Thomas Boasberg
Mr. James Coltharp
Mr. Daniel Gonzalez
Mr. James Casserly
Ms. Regina M. Keeney
Mr. A. Richard Metzger, Jr.
Ms. Kathleen B. Levitz
Mr. John Nakahata
Mr. Joseph Farrell
Mr. James D. Schlichting
Mr. Richard K. Welch
Mr. Patrick DeGraba

Attachment 1

Estimated Impact on the IXCs.
The proposed plan puts no pressure on IXCs to raise toll rates.

One of the key issues in analyzing any proposal on Universal Service and Access Reform involves estimation of the impact of the proposal on IXCs and specifically the potential impact on toll rates. This section discusses:

1. estimated impacts of the FCC's Staff proposal on the IXCs and potentially on toll rates; and,
2. change in any impacts as a result of implementing the suggested adjustments to the Staff's proposal discussed in sections 3 and 4.

The analysis reviews impacts starting on July 1997, the subsequent impacts expected on January 1998, and annually from July 1998 through July 2000. The analysis demonstrates that with only a few changes in timing and without any upward adjustment in the LEC productivity offset, universal service obligations can be fully funded and long distance carriers will benefit from a positive financial impact.

<u>General Comments:</u>

Universal Service Implementation Impacts

The implementation of Universal Service support for the new social programs (i.e., funding for schools & libraries and rural healthcare) will require assessments on the IXCs, LECs and others for payments to the fund administrator. The assessment is assumed to be based on the carrier's percentage of combined interstate and intrastate retail revenues to the total base of interstate and intrastate retail revenues. Over the period of the analysis, an average, approximately 38% of the new social funding obligation will be assessed to the IXCs.

Currently the IXCs fund 100% of Lifeline/Link-up and Large LEC and Rural high cost funds (estimated at $1,680M annually). These funds are collected via direct assessments and charges included in the access rates IXCs currently pay. On January 1, 1998 it is expected that funding for these universal service amounts will be provided from IXC, LECs and other telecommunication providers. The assessment related to these funds is expected to be based on interstate retail revenues only. On average, approximately 76% of Lifeline/Link-up and high cost funding obligations will be assessed to the IXCs over the analysis period. This funding change will result in savings to the IXCs.

The amounts of universal service funding assessed to the LECs will result in exogenous adjustments to IX (corridor), special access (retail) and total end-user common line rates.

The amount allocated to total end-user common line rates will flow back to the IXCs via restructured access charges and amounts to approximately 85% of the total LEC funding obligation.

Price Cap Impacts

Rate reductions under normal price cap rules are presumed to continue. The underlying assumption is a productivity factor of 5.3% (non-sharing) and an inflation factor of 2.7%.[1] Rate reductions from annual price cap filings are shown as a savings/cost offset to the IXCs.

Impact of Changes in SLC Rates

Additional revenues generated by increases to SLC caps for multiline business and non-primary residence lines will result in decreases to access charges. These reductions are also included as a savings/cost offset to the IXCs.

PICC (PSL) Pass-Through

We understand that the staff has assumed that the IXCs will pass through PICC (PSL) charges to multiline business customer only. The revenues gained by such a pass-through will provide additional resources that will offset any additional costs.

Long Distance (LD) carriers generally have contracts with their business customers covering the provision of telephone services. The contracts are developed through negotiation between the LD carrier and the customer and consequently are tailored to the customer's specific needs, including the rates, terms and conditions for the provision of service.

There has been some discussion regarding the restructure of access charges and the impact on LD carrier's contracts, e.g., whether and how changes in the structure will be passed along to their customers. If the restructure of access charges does not change the total amount collected (i.e., the restructure is revenue neutral), LD carriers can continue to use their existing rate structures and rates without any financial harm. However, if the LD carriers want to reflect the effect of the restructured access charges in their contracts, depending on the terms in their individual contract, they may be able to adjust the price structure under their contract or they may be able to renegotiate the terms of the contract.

LD carriers have argued that they will face reduced revenues due to the unique circumstance of their contracts with certain business customers. This results from the

[1] This modeling assumption may overstate the LEC inflation adjustment. For example, in the current Tariff Review Plans, the inflation factor is 2.1%.

access restructure's lowering of the per minutes charges, including the federal government. While any contract must be evaluated by the specific contract language, it is not necessarily the case that just lower per minute charges would be passed along without recognition of the new per line charges. These contracts usually contain specific provisions related to adjustments in the contract's rates. Generally, these fall into two categories:

- arrangements where changes in rates are applied to the contract's rates via a surcharge; and
- arrangements where there are scheduled competitive reviews built into the contract

In the case where rate changes are passed through via a surcharge approach, it is not reasonable to reflect only one part of the change (the lower per minute rate) without taking into account the new per line charges. If, however, that is the position the LD carrier finds itself in, most contracts usually contain provisions that allow negotiated changes in terms based on changed conditions, e.g., changes mandated by regulatory agencies.

In the case of competitive reviews, the customer usually exercises this provision to obtain a better rate by considering the competitive alternative available in the market place. The customer will use results of the review to renegotiate the contact's rates. However, the LD carrier can utilize such a negotiation to make modifications it feels is necessary.

Thus, the assertion that LD carriers will be hurt from the restructure of access due to the unique contracts is inaccurate.

Impact on Toll rates

The amount of any additional Universal Service obligations, net of rate reductions and other cost offsets are considered to be eligible for recovery by the IXCs from interstate and intrastate toll rates, private line services and other products and services. Based on 1995 TRS data, interstate and intrastate toll revenues represent approximately 72% of the IXCs total revenues. The "toll only" impact is calculated by applying this 72% factor to selected items.

Summary of IXC Impacts:

Chart 1: Base Case - Incremental Impacts

As shown on Chart 1, the full implementation of the Social funds at \$2.65B (Education fund of \$2.25B and Healthcare fund of \$400M) on July 1, 1997 results in a net incremental impact on the IXCs of \$949M. Incremental impacts in subsequent periods result in significant incremental savings to the IXCs ranging from \$.5B to \$2.6B.

Detailed supporting data are found in worksheet 1.

Chart 2: Base Case - Cumulative Impacts

On a cumulative basis, the initial impact of full implementation of the Social funds is fully absorbed in the second period (January 1998) and savings growing to a cumulative total of $4.7B by the year 2000.

Detailed supporting data are found in worksheet 2.

Chart 3: Transition Proposal - Incremental Impacts

A transition of the Social funds coupled with advancing the implementation of the increase in the multiline business SLC cap totally mitigates the initial impact on IXCs as shown in Charts 1 and 2. The following is a summary of the proposed transition of the Social funds:

	July 1997	Jan. 1998	July 1998	July 1999	July 2000
Education	1,250	1,250	2,250	2,750	2,750
Healthcare	50	50	100	150	200
Total	1,300	1,300	2,350	2,900	2,950

Detailed supporting data are found in worksheet 3.

Chart 4: Transition Proposal - Cumulative Impacts

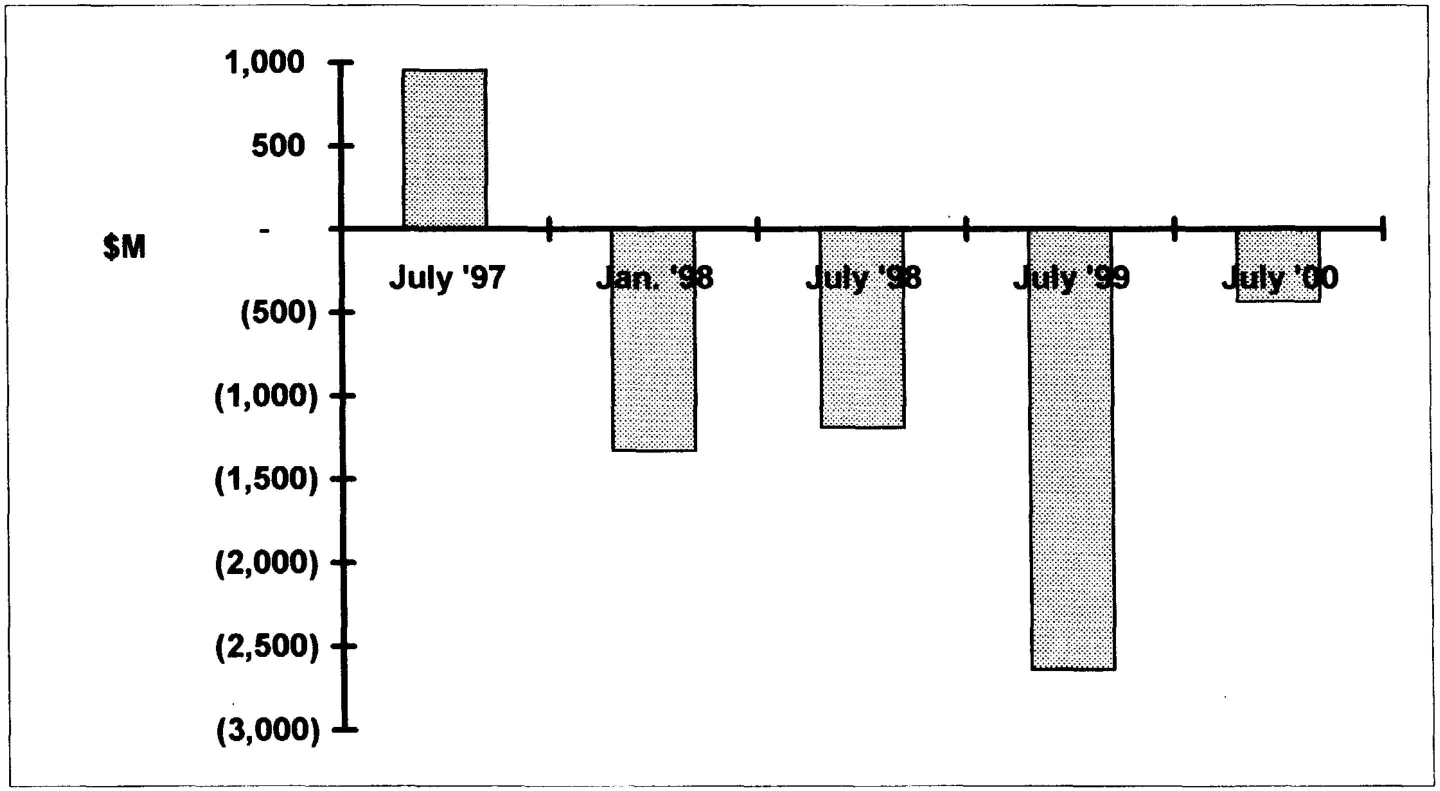
On a cumulative basis, the transition proposal clearly smoothes the impacts and savings which accrue to the IXCs. The IXCs under the transition proposal initial gain a $106M savings which grows to $4.6B by the year 2000.

Detailed supporting data are found in worksheet 4.

Chart 1

Universal Service/Access Reform
Estimated Impact on IXCs
Incremental View

Assumption: **Base Case**



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Universal Service/Access Reform
Estimated Impact on IXC
Cumulative Annual View

Chart 2

Assumptions: **Base Case**

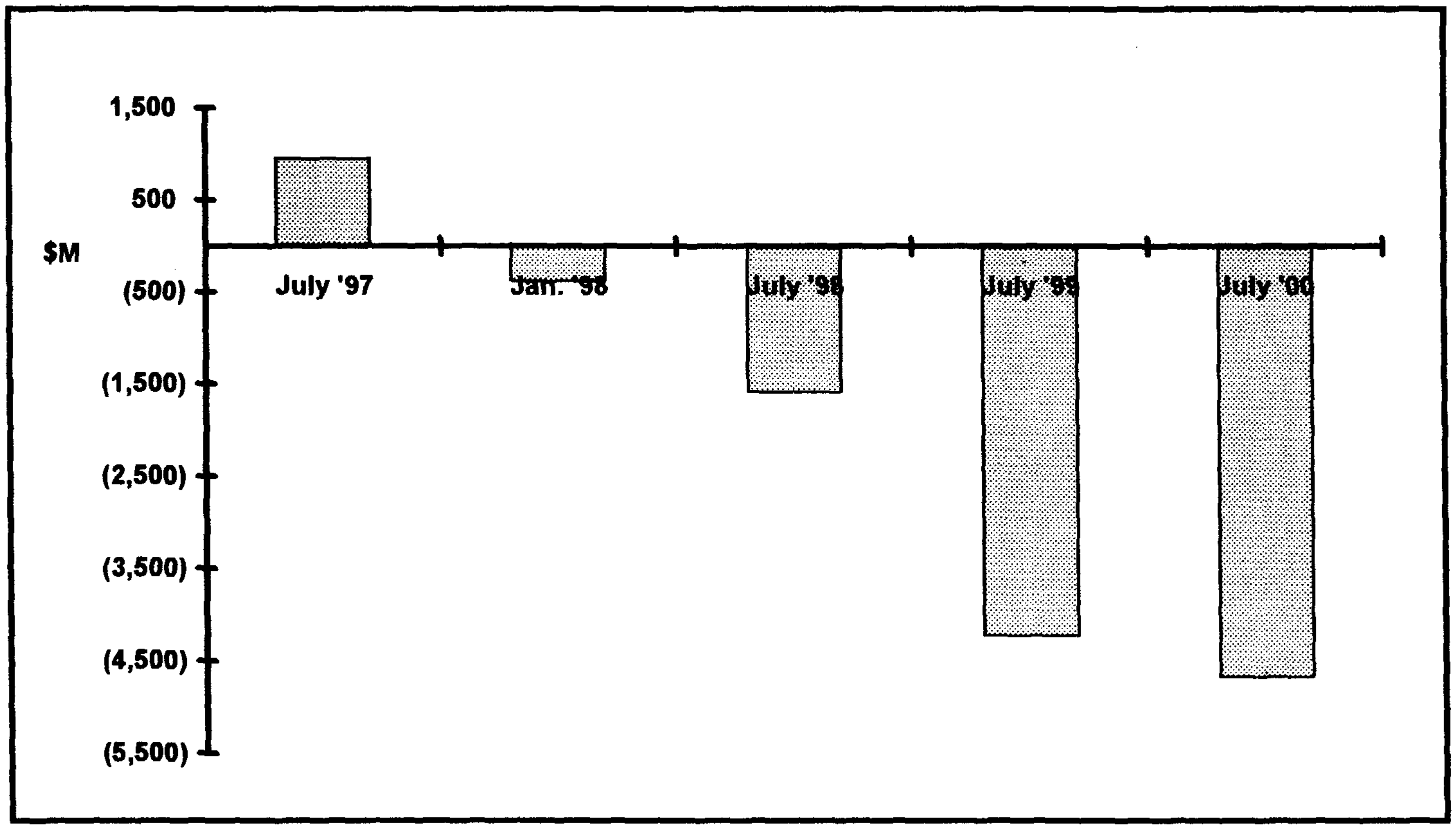

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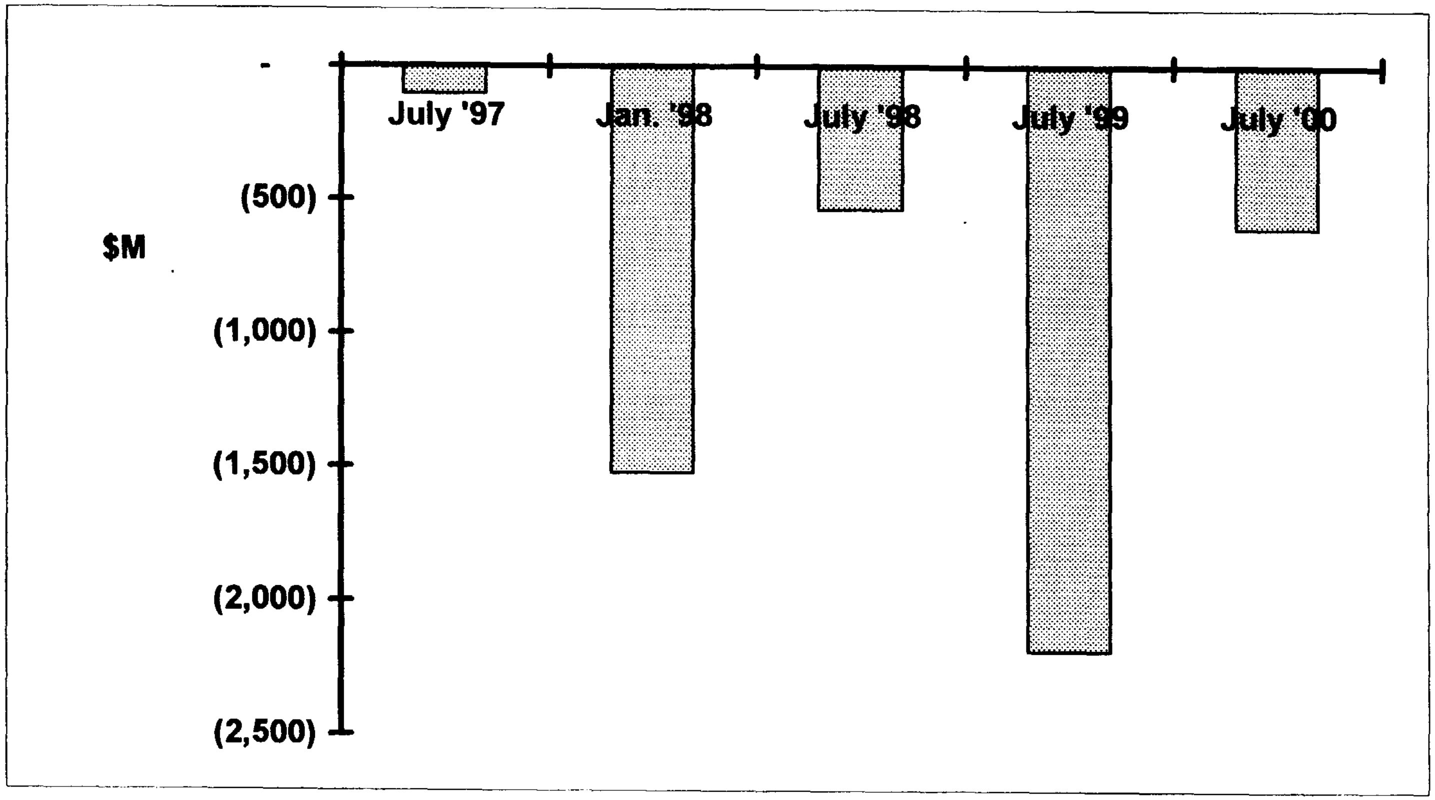
Chart 3

Universal Service/Access Reform
Estimated Impact on IXCs
Incremental View

Assumption: **Transition Proposal**



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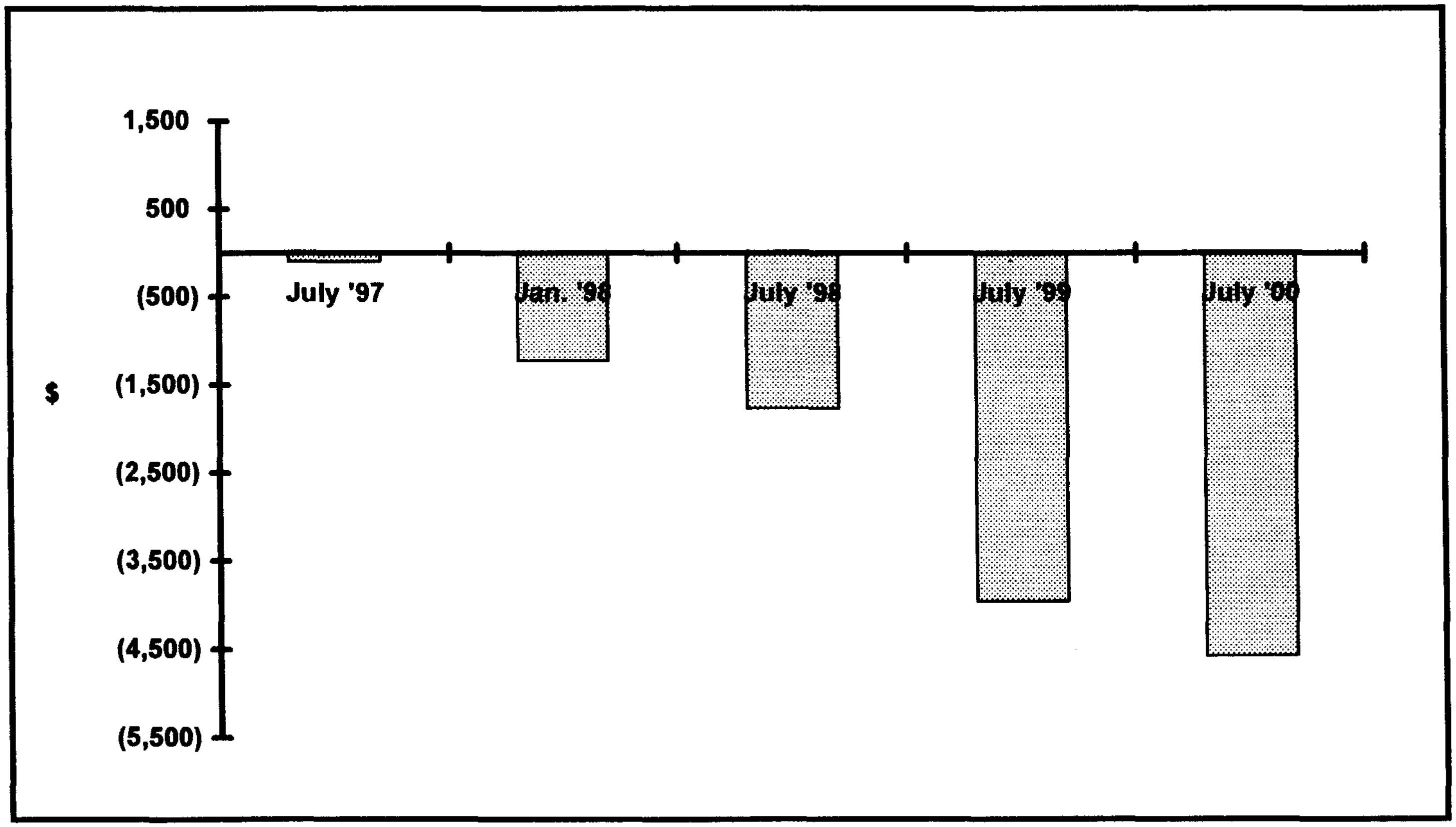
Universal Service/Access Reform
Estimated Impact on IXC
Cumulative Annual View

Chart 4

Assumptions: Transition Proposal



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Universal Service/Access Reform
Estimated Impact on IXCs
Incremental View

Worksheet 1

($ Millions)

Assumptions: **Base Case**

July 1997

	Total	IXC	Toll	Net Impact
Social Funds	2,650	1,018	732	
LEC Flowback		946	946	
Price Cap	(729)	(729)	(729)	
Net Impact	1,921	1,235	949	
				949

Jan. 1998 *(Changes from July 1997)*

	Total	IXC	Toll	Net Impact
Lifeline	320	204	146	
High Cost		(350)	(251)	
LEC Flowback		200	200	
SLC Change	(866)	(866)	(866)	
Net Change	(546)	(812)	(771)	
PIC pass-through			(561)	(1,332)

July 1998 *(Changes from Jan. 1998)*

	Total	IXC	Toll	Net Impact
Social Funds	-	-	-	
LEC Flowback		(9)	(9)	
Price Cap	(599)	(599)	(599)	
SLC Change	(17)	(17)	(17)	
Net Change	(616)	(625)	(625)	
PIC pass-through			(569)	(1,194)

July 1999 *(Changes from July 1998)*

	Total	IXC	Toll	Net Impact
Social Funds	-	-	-	
High Cost	2,500	(446)	(321)	
LEC Flowback		(1,391)	(1,391)	
Price Cap	(612)	(612)	(612)	
SLC Change	(155)	(155)	(155)	
Net Change	1,733	(2,604)	(2,478)	
PIC pass-through			(164)	(2,642)

July 2000 *(Changes from July 1999)*

	Total	IXC	Toll	Net Impact
Social Funds	-	-	-	
High Cost		(169)	(122)	
LEC Flowback		40	40	
Price Cap	(621)	(621)	(621)	
SLC	(150)	(150)	(150)	
Net Change	(771)	(900)	(853)	
PIC pass-through			414	(439)

Universal Service/Access Reform
Estimated Impact on IXCs
Cumulative Annual View
($ Millions)

Assumptions: **Base Case**

	July '97	Jan. '98	July '98	July '99	July '00
Universal Service					
- Schools & Libraries	864	857	853	848	844
- Rural Healthcare	154	152	152	151	150
- Lifeline/Link-up	180	384	382	120	101
- Large LEC High Cost	300	230	229	601	507
- Rural LEC High Cost	1,200	920	917	361	304
Total Obligation	2,698	2,544	2,532	2,081	1,907
Add: Access Flowback	946	1,146	1,137	(254)	(214)
Less: Current Payment	(1,680)	(1,680)	(1,680)	(1,680)	(1,680)
Net Obligation	1,964	2,009	1,989	147	13
Offsets:					
- Price Cap	(729)	(729)	(1,328)	(1,940)	(2,561)
- SLC Change	-	(866)	(883)	(1,038)	(1,188)
- PIC Pass-Through		(561)	(1,130)	(1,294)	(880)
Total Offsets	(729)	(2,156)	(3,341)	(4,272)	(4,629)
Net IXC Impact	1,235	(147)	(1,352)	(4,124)	(4,616)
Toll Only Impact	**949**	**(389)**	**(1,592)**	**(4,237)**	**(4,680)**

Universal Service/Access Reform
Estimated Impact on IXCs
Incremental View

Worksheet 3

($ Millions)

Assumptions: **Transition Proposal**

July 1997

	Total	IXC	Toll	Net Impact
Social Funds	1,300	499	359	
LEC Flowback		464	464	
Price Cap	(929)	(929)	(929)	
Net Impact	371	34	(106)	
				(106)

Jan. 1998 *(Changes from July 1997)*

	Total	IXC	Toll	Net Impact
Lifeline	320	204	146	
High Cost		(350)	(251)	
LEC Flowback		205	205	
SLC Change	(1,066)	(1,066)	(1,066)	
Net Change	(746)	(1,007)	(966)	
PIC pass-through			(561)	(1,527)

July 1998 *(Changes from Jan. 1998)*

	Total	IXC	Toll	Net Impact
Social Funds	1,050	398	286	
LEC Flowback		362	362	
Price Cap	(599)	(599)	(599)	
SLC Change	(17)	(17)	(17)	
Net Change	434	144	33	
PIC pass-through			(569)	(536)

July 1999 *(Changes from July 1998)*

	Total	IXC	Toll	Net Impact
Social Funds	550	207	149	
High Cost	2,500	(446)	(321)	
LEC Flowback		(1,087)	(1,087)	
Price Cap	(612)	(612)	(612)	
SLC Change	(155)	(155)	(155)	
Net Change	2,283	(2,092)	(2,025)	
PIC pass-through			(164)	(2,188)

July 2000 *(Changes from July 1999)*

	Total	IXC	Toll	Net Impact
Social Funds	50	19	13	
High Cost		(169)	(122)	
LEC Flowback		(141)	(141)	
Price Cap	(621)	(621)	(621)	
SLC	(150)	(150)	(150)	
Net Change	(721)	(1,063)	(1,021)	
PIC pass-through			414	(607)

Universal Service/Access Reform
Estimated Impact on IXCs
Cumulative Annual View
($ Millions)

Worksheet 4

Assumptions: **Transition Proposal**

	July '97	Jan. '98	July '98	July '99	July '00
Universal Service					
- Schools & Libraries	480	476	853	1,037	1,031
- Rural Healthcare	19	19	38	57	75
- Lifeline/Link-up	180	384	382	120	101
- Large LEC High Cost	300	230	229	601	507
- Rural LEC High Cost	1,200	920	917	361	304
Total Obligation	2,179	2,029	2,419	2,176	2,019
Add: Access Flowback	464	669	1,032	(55)	(196)
Less: Current Payment	(1,680)	(1,680)	(1,680)	(1,680)	(1,680)
Net Obligation	963	1,019	1,770	441	143
Offsets:					
- Price Cap	(729)	(729)	(1,328)	(1,940)	(2,561)
- SLC Change	(200)	(866)	(883)	(1,038)	(1,188)
- PIC Pass-Through		(561)	(1,130)	(1,294)	(880)
Total Offsets	(929)	(2,156)	(3,341)	(4,272)	(4,629)
Net IXC Impact	34	(1,137)	(1,571)	(3,831)	(4,485)
Toll Only Impact	**(106)**	**(1,235)**	**(1,778)**	**(3,970)**	**(4,581)**

Any Access Rate Level Reduction Should Not Drive Returns Below 10.25%

While the Commission believes it is appropriate to bring per-minute charges down, those benefits will be illusory if the rate changes impair the ability of LECs to support and invest in the local network. In particular, if the Commission were to order a cut in overall rate levels -- a decision that is not justified under the facts in the record in this proceeding -- it should in no event mandate cuts that would force returns down to below a point that the Commission has already found to be a floor.[1]

Under current rules the Commission has recognized that interstate returns below 10.25% should trigger the ability to raise rates. In the price cap review order, the Commission rejected arguments that the 11.25% benchmark and the 10.25% floor be adjusted downward. Based on interest rates at that time, the Commission found that "represcription of the rate of return is not indicated."[2] The economic evidence in the current record also does not support any change. Dr. Randall Billingsley offered testimony that as of January 1997, the average yield on 30-year Treasury bonds did not support any decrease in the allowed rate of return.[3] Since then, the Federal Reserve Board has raised short-term interest rates and the average yield on long term bonds has risen.[4] In addition, the passage of the Telecommunications Act and the increase in LEC competition has increased the business risk faced by LECs, and thereby increased their economic cost of capital.[5] In sum, there is no basis to suggest that the 10.25% floor should be lowered.

In order to avoid pushing rates below that point, the Commission should require that any reductions should be capped, such that using the most recent annual results (1996) as a base year, no companies' earnings would be reduced below 10.25%. In particular, the following mechanism could be put in place:

STEP 1:
Companies will calculate new indices in their 1997 Annual Filing using the new rules.

STEP 2:
Calculate the impact of the price cap filing on the revenues of the regulated company. For each price cap basket (except common line which is dealt with in Step 3), subtract the new 1997 annual filing price cap index from the index just prior to that filing ("old index"). Divide the result by the old index. This percentage change is then multiplied by the revenues for that basket (1996 demand times existing rates, also known as the R value).

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1 *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961, 9050 (1995).
2 *Id.* at ¶ 231-232.
3 The yield at the time was 6.82%. Statement of Dr. Randall S. Billingsley at 7-9, Attachment 13 to USTA Reply Comments (filed Feb. 14, 1997).
4 The Washington Post's Report of the Lehman Brothers Treasury Bond Index as of April 28, 1997 was 7.21%.
5 Statement of Dr. Randall S. Billingsley at 4-7.

STEP 3:

Calculate the impact on revenues for the Common Line basket. This calculation is slightly different because price cap rules require that the values for the carrier common line charges in the Common Line basket must be adjusted to remove half of the per-minute growth. For the Carrier Common Line amount, subtract the old price cap index from the new 1997 annual filing price cap index and divide by the old price cap index to arrive at a percentage change. Multiply the result by the Carrier Common Line revenues only. This is the Carrier Common Line revenue impact.

Next, to calculate the subscriber line charge ("SLC") revenue impact, the company will need to re-run their annual filing Common Line price cap index calculation assuming no growth in minutes of use per line (set "g" to zero). Take this "no-growth price cap index" and subtract it from the old Common Line price cap index. Divide this result by the old price cap index. Multiply the resulting percentage change by the 1996 SLC revenue.

For the total common line revenue impact add the above Carrier Common Line impact with the SLC revenue impact.

STEP 4:

Calculate the total impact of the price cap filing on revenues. Add all of the basket results calculated in steps 2 and 3.

STEP 5:

Recalculate the company's rate of return to reflect the revenue impacts. The company should take 1996 revenues and subtract the impact of the 1997 annual filing as calculated in step 4. These are the adjusted revenues. Next, take the revenue impact (from step 4) and multiply it by the effective composite (state and federal) tax rate for the company. Subtract this result from 1996 expenses and taxes. This is the adjusted expenses and taxes. Adjusted net income is calculated by subtracting the adjusted expenses and taxes from the adjusted revenue. Recalculate rate of return using this adjusted net income.

STEP 6:

Companies then must determine if the adjusted Rate of Return is below the 10.25% floor. For those companies who fall below 10.25%, an exogenous cost change is required to be made to each of the baskets to get the company's adjusted net income to equal 10.25%

In order to develop an exogenous amount needed to raise the company to the 10.25% return level, the following steps are needed:

A. Subtract the adjusted return from 10.25%.
B. Multiply the result by the rate base (as per 1996 Form 492). This amount is the net income change need to arrive at the 10.25% level.

C. Divide the amount calculated in step B by the effective tax rate used in step 5.
D. The amount calculated in step C is the total amount exogenous cost change needed. This is then distributed to the baskets based on revenue impact weights. To calculate the weights, divide each of the basket amounts developed in steps 2 and 3 by the total impact amount (step 4). Multiply the weights by the exogenous cost change amount in step C.

STEP 7:

New price cap indices are run with the new exogenous cost changes reflected in the index.

Attachment 3

Long Distance Carriers Are Free To Set Their Own Rate Structure

AT&T and other carriers have no basis to complain that a restructure of access charges will reduce their revenues and will thereby require them to raise their basic toll rates. Since the Commission order that AT&T be classified as a non-dominant carrier,[1] all interexchange carriers have flexibility to set their own rate structure free of regulatory constraint. Regardless, so long as the restructure of access charges does not change the total amount collected (i.e., the restructure is revenue neutral), long distance carriers can continue to use their existing rate structure without any financial harm.

Today, access charges are incurred primarily on a per-minute basis, but long distance carriers also incur fixed charges for switched transport and certain universal service obligations. Long distance carriers charge their customers through a variety of tariff promotions, contracts and associated rate plans that combine fixed and per-minute charges. For example, the interexchange carriers offer residential rate plans that have minimum usage obligations which combine a minimum monthly line charge with per-minute charges that are discounted from their higher base tariff rates.

Were the Commission to mandate access reform that did nothing else but shift the basis of LEC switched access charges to a combination of per-line charge and reduced per-minute charges, the long distance carriers would have complete flexibility to adjust their own rates (or not) to better reflect how their costs would be incurred. If they made no changes, they would still incur the same costs and collect the same revenues. Long distance carriers might nevertheless wish to adjust their rate structure to increase profitability -- if they believed that reduced per-minute charges (combined with per-line charges) would stimulate demand. Or they may be compelled to reduce per-minute rates as a result of competitive pressure from other carriers -- for example, if Bell companies were allowed to offer long distance and began doing so at lower rates. None of these potential changes support claims that long distance carriers would suffer from access reform, and in no event justify additional reductions to the overall level of access charges.

AT&T has argued that it will face reduced revenues due to the unique circumstance associated with its long-term contracts with the federal government. While any contract must be evaluated by the specific contract language and AT&T has failed to put the relevant contract provisions on the record, it nevertheless makes no sense to suggest that AT&T is under some special duress for these contracts. AT&T presumably retains the right to leave its rates to the federal government unchanged. Because its total costs are not increasing as a result of access restructure, it would be no worse off. If the government seeks a rate reduction based on AT&T's lower per-minute costs, AT&T can use the reopening of the contract terms to negotiate for a higher per-line charge.

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1 *Motion of AT&T to be Reclassified as a Non-Dominant Carrier*, 11 FCC Rcd 3271 (1995).

Similarly, if AT&T is contractually compelled to pass through any reductions in the per-minute access rate, it still may argue that those changes are linked to the increase in per-line costs, and that it cannot be compelled to change one rate without the ability to change the other.

Moreover, if it is like most contracts, including government telecommunications contracts, AT&T's agreements also contain provisions that allow it to negotiate changes in terms based on changed conditions. In particular, contractors may seek increased compensation under specific contract allowances or through the standard government contract "changes clause."[2] For example, Bell Atlantic's own government contracts contain specific language that allow it to request price increases due to increased costs in general and changes in the tariffed price of connecting of the government service to the local network in particular.[3]

Courts and administrative boards have accepted AT&T's arguments that because of its duration and scope, AT&T's primary government contract -- the FTS2000 contract -- is intended to be "a living contract" that could be adjusted as circumstances changed.[4] As a result, "a broad range of modifications would fall within the scope of [the contract's] change clause."[5] This suggests that if the changes contemplated in access reform -- which have been under consideration by the Commission for years -- do not trigger an ability for AT&T to negotiate a change in contract rates, the fault lies with AT&T when it negotiated the contract in the first place. In any event, it provides no justification to saddle AT&T's other customers with a rate increase to make up for any shortfall, or to force access rates lower to cover a one-sided contract negotiated by AT&T.

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2 *See Geronimo Service Co.*, ASBCA 14686, 70-2 BCA ¶ 8540, finding a constructive change that allowed a price increase in a contract where the Labor Department required that a contractor compensate its employees based on an updated schedule of minimum wages and benefits, thereby increasing the costs of its contract with the Navy.

3 Bell Atlantic WITS Contract, ¶ B.6 SCHEDULE E: TARIFFED CHANGES.

4 *Protest of MCI Telecommunications Corp.*; GSBCA No. 10450-P, 1990 GSBCA LEXIS 86; *27; 90-2 B.C.A. (CCH) P22,735.

5 *AT&T v. Wiltel, Inc.*, 1 F.3d 1201, 1206 (Fed. Cir. 1993).

Attachment 4

AN ANALYSIS OF THE EFFECTS OF EXCHANGE ACCESS REFORM ON DEMAND STIMULATION

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I. INTRODUCTION

The Federal Communications Commission (FCC) is considering a unique change to exchange access cost recovery that will result in more cost being recovered through flat charges to Interexchange Carriers (IXCs).[1] These changes are being made to improve the economic alignment of cost recovery with rates by recovering Non-Traffic Sensitive (NTS) costs through per-line charges and Traffic Sensitive (TS) costs through per-minute charges. The FCC is considering the implementation of a revenue neutral restructure of LEC access rates in which reductions in the per-minute exchange access rate will be offset by a new Presubscribed Line (PSL) charge.[2]

In this document and the attached Technical Appendix, we discuss our findings regarding the impact on access demand and the associated changes in contribution (price less incremental cost) that are likely to result from the per-minute access rate reduction that will accompany the PSL. The analysis indicates that when all possible scenarios are examined, access service demand changes could range from a -6.03 percent to 7.05 percent. Contribution changes for the IXC industry range from $0.000 to $3.340 billion. Contribution changes for the LEC industry range from -$0.390 billion to $0.455 billion. Although the rate structure change may initially be revenue neutral for the LECs and cost neutral for the IXCs, the result of this study indicate that there is likely to be a greater opportunity for margin/contribution growth for the IXCs.

If we assume that the PSL will be recovered using IXC flat per-line charges, demand stimulation ranges from 0 percent to 7.05 percent and contribution changes range from $1.616

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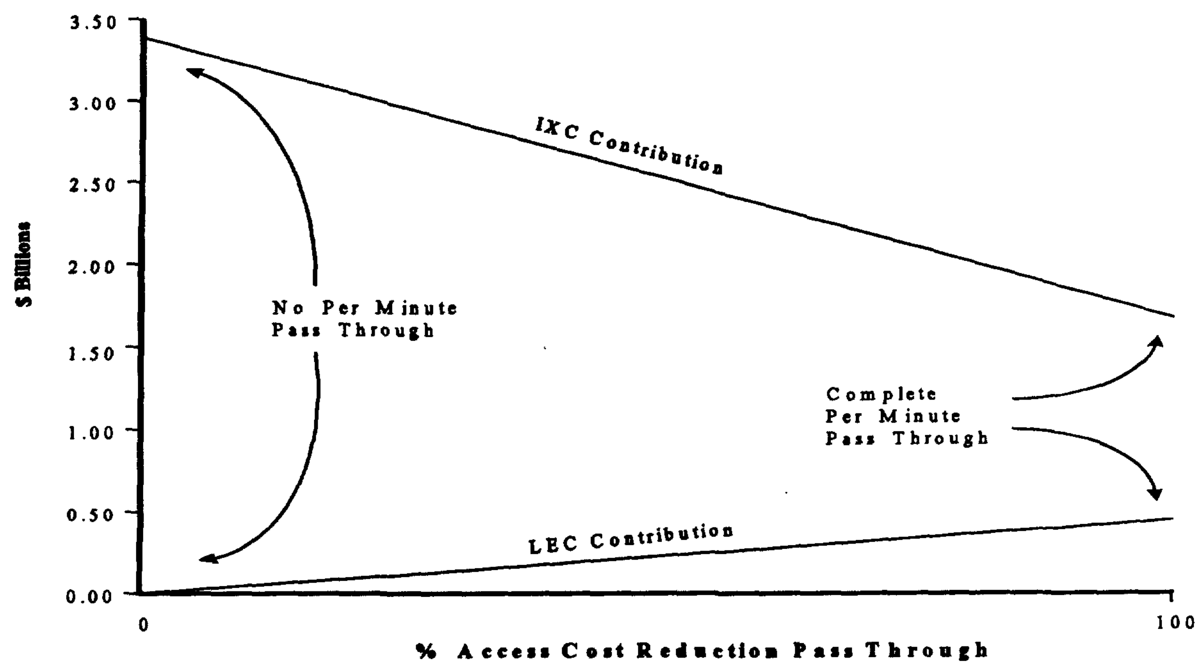
[1] *In the Matter of Access Charge Reform, et. al.*, CC Dockets Nos. 96-262, 94-1, 91-213, 96-263, released December 24, 1996.

[2] Specifically, we expect that a per-minute access rate reduction will be compensated by (i) recovering Carrier Common Line Charges on an (NTS) basis, (ii) recovering NTS local switching costs on an NTS basis, (iii) recovering non service-related Transport Interconnection Charges (TIC) on an NTS basis, and (iv) implementing a Presubscribed Line (PSL) charge to (IXCs) to recover interstate NTS exchange access revenues.

billion to 3.341 billion and from 0 to $0.455 billion for IXCs and LECs respectively. This is illustrated in Figure 1.

Figure 1
Contribution Changes



Following, we briefly describe the study approach, describe our methodology and present results from the study.

II. THE STUDY APPROACH

We make assumptions about how much revenue recovery will shift from TS to NTS (from the current per-minute access rate to a new flat rate) and then estimate (i) the likely, industry-wide switched access quantity demand changes (stimulation or repression), and (ii) the industry-wide impact of those demand changes on both LEC and IXC margin (contribution). We interpret "revenue neutral" to mean that the LECs have no more or less revenue, at zero stimulated minutes, under access reform (charging a reduced per-minute access rate and receiving PSL revenue from the IXCs) than with current access rates—adjusted for the SLC increase—and quantity of access minutes.

Recognizing the derived demand nature of exchange access—access demand is dependent upon toll service demand—our estimate of access quantity demand changes requires an analysis of both the access and toll services markets. Access reform will require that LECs reduce per-minute access charges to IXCs, all or part of which an IXC is free to pass through to its toll customers or retain for its shareholders. The impact of access reform on demand will ultimately be determined by the price changes that IXCs elect to implement. In addition, IXCs will be required to pay LECs a PSL charge. The IXCs are free to choose how they obtain funds to pay the PSL charge. The PSL will be recovered from customers through either (i) a per-line charge (ii) a per-minute charge or (iii) a combination of both per-line and per-minute charges. Four scenarios bound the possible actions of the IXCs and the solutions to the equations in the Technical Appendix. Herein we focus on two—each when the IXCs recover the PSL using per-line charges—and evaluate the impact of the IXC's decision to pass through the per-minute access cost reduction.[3] They are:

1. A full pass through of the per-minute access rate reduction and a flat end user charge to recover the PSL
2. No pass through of the per-minute access rate reduction and a flat end user charge to recover the PSL.

III. METHODOLOGY

The theory underlying our calculations and a detailed description of the formulae we used is presented in the Technical Appendix. We begin by recognizing that changes in the quantity demanded of exchange access are dependent on equilibrium changes in the toll market after exchange access reform. As a result, we do not calculate changes in access quantity demanded directly, rather we first estimate changes in output in the toll market and then examine changes in the quantity demanded of exchange access. Toll demand is a function of toll prices

[3] Other scenarios are (i) a full pass through of the per-minute access rate reduction and an increase in the per-minute toll rate to recover the PSL and (ii) no pass through of the per-minute access rate reduction and an increase in the per-minute toll rate to recover the PSL.